

The eastern members of the EU: catching up fast

Anna Dorbec

This article analyses the recent economic performances of the eastern countries of the European Union, specifically focusing on the so called Visegrad-6 group, comprising Poland, Hungary, the Czech Republic, Slovakia, Bulgaria and Romania. Long considered as the EU's "junior partners", their very strong macroeconomic performances in recent years suggest that they will soon catch up with their western EU counterparts. Are we about to witness the culmination of more than 10 years of convergence? Only if we ignore the structural challenges these economies are still facing.

This article examines the economic performances of the Visegrad-6 (V-6), which comprises the original Visegrad-4 (Poland, Hungary, the Czech Republic and Slovakia) which joined the EU in 2004 as well as Bulgaria and Romania, which joined in 2007. Together, these six countries account for 61% of the GDP of central and Eastern Europe¹, and 86% of the region's population. Of these countries, only Slovakia is a member of Eurozone.

Part one will examine the real economy, including growth and competitiveness. Part two will look at macro-financial convergence, including inflation, interest rates and macroeconomic imbalances. Part three will analyse the structural aspects such as demographics and innovation capacity. By examining these three vectors, we will try to define the region's future short and medium to long-term trajectories and risks.

Performance of the real economy

Eastern Europe's economic performances have caught the world's attention. The region reports the most dynamic GDP growth in the EU. Since year-end 2016, the region seems to benefit of the rebound in world growth, the upturn in international trade and the improvement in investor confidence. Since they joined the EU, the V-6 countries have consistently outperformed the averages of both the EU and the Eurozone (table 1).

Average growth (geometric mean)

	V-6	European Union	Eurozone
2010-16	2.3%	1.3%	1.1%
2008-09	0.1%	-2.0%	-2.1%
2004-07	6.1%	2.7%	2.6%

Table 1

Sources: Eurostat, BNP Paribas

¹ The region of Central and Eastern Europe (CEE) includes the old «eastern Bloc» countries (Bulgaria, Hungary, Poland, Romania, Albania), the countries issued from the dissolution of Yugoslavia (Croatia, Slovenia, Serbia, Bosnia-Herzegovina, Macedonia, Montenegro and Kosovo...), and of Czechoslovakia (Czech republic and Slovakia) as well as the Baltic states (Lithuania, Latvia and Estonia, old soviet republics).

Although growth has slowed sharply since 2010, the V-6 continue to grow at significantly faster rates than the EU and eurozone averages. With the exception of Poland, which avoided recession, the others all passed through recessionary periods. For the region as a whole, growth rebounded in 2010-2011, except Hungary and the Czech Republic, where GDP continued to contract in 2012 (2012 and 2013 for the Czech Republic). Since 2014, however, these troubles have been a thing of the past, and real GDP exceeded its 2008 peak, except in Bulgaria (chart 1). The catching-up movement has resumed again, buoyed by very strong industrial performances (chart 2).

Real GDP growth above the EU average

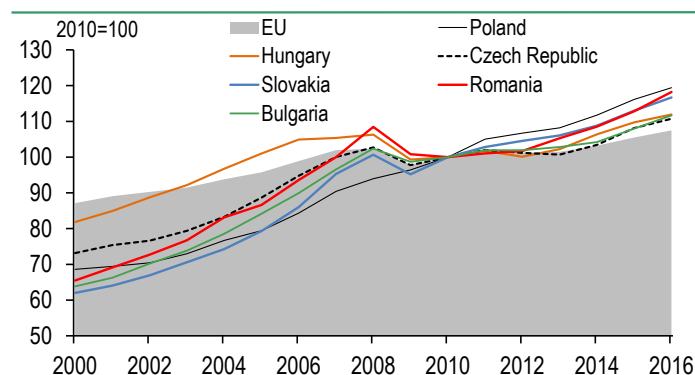


Chart 1

Sources: IMF, Eurostat, European Commission, BNP Paribas

Industrial boom

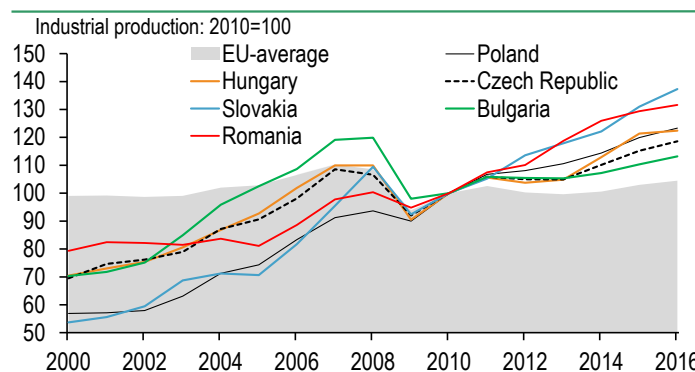


Chart 2

Sources: IMF, Eurostat, European Commission, BNP Paribas



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Acceleration in industrial activity and gains in market shares

Eastern European industrial performances have surpassed the EU average since 2001. The only exception is 2009, when industrial activity in four of the six countries contracted by more than for the EU as a whole, which reflects the importance of sub-contracting activities linked to the European industrial giants, who sharply reduced their orders in response to the uncertainty of the financial crisis. But the industrial sectors of the V-6 quickly swung back into growth. The year 2012 was also tough, undermined by fears about the sovereign debt crisis. Once again, Eastern European industries adapted very quickly and managed to pull through the crisis. Although European industry as a whole has grown only 2.5% since 2004, the V-6 countries have staged an impressive industrial performance: over the same period, industrial production rose 18% in Bulgaria and 93% in Slovakia, respectively the region's weakest and strongest industrial performances (chart 2).

The V-6 countries gained market shares within the EU thanks to a skilled but low-cost labour force, an institutional environment rapidly catching up with European standards, and the absence of customs barriers. This created a propitious environment for international groups to set up new production units and to develop outsourcing, notably in the automobile sector, where Germany remains the main player in this new industrial fabric.

The wage gap is narrowing at an accelerated pace, buoyed by a spectacular improvement in the labour market

The V-6 economies still benefit from the advantages of low-cost labour (chart 3). Slovakia pays the highest wages of the group, at EUR7.8 per hour in 2016, but wage costs there are only 30% of the EU average. Bulgaria pays the lowest wages, with average hourly wages of EUR 3.7, which is only 14% of the European average (EUR 25.9 in 2016). Nonetheless, the wage gap has been narrowing over the years and this catching-up movement has even accelerated since 2014. In the first half of 2017 nominal wages soared by 15% year-on-year in Romania, by 10% in Bulgaria and by 9% in Hungary, compared with the average growth of less than 2% in the EU as a whole.

With the notable exception of the Czech Republic, wage increases are once again exceeding productivity gains, although the situation still has not returned to 2007 levels. If the gap between wage increases and productivity holds at current levels, we are likely to see the competitiveness of these countries gradually erode. This makes it even more vital for the V-6 to make the "qualitative leap", i.e. to switch from outsourcing for European industrial groups to the development of integrated national industrial groups and more innovative activities.

Recent labour market trends point towards the continuation in wage acceleration. After a long period of severe underemployment (notably in Poland, Slovakia and Hungary), unemployment rates have been declining since 2013. Today unemployment rates are at their all-time lows, and below the European average (chart 6).

Labour demand is also on the rise. Companies complain of a lack of skilled labour. The surplus labour demand is mainly due to vigorous growth, but it also reflects the aggravation of demographic trends over the past twenty years (declining birth rates and aging populations).

These trends are straining the active population, which declines in Poland, Bulgaria and Romania, and increases very mildly in Czech republic and Slovakia (chart 7). Only Hungary seems to have bucked this trend, with an ongoing increase in the active population since 2010.

Wage gap with the EU average is still high

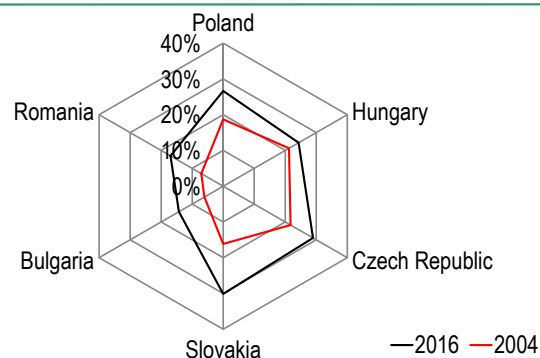


Chart 3

Sources: Eurostat, BNP Paribas

Nominal wage growth: another acceleration

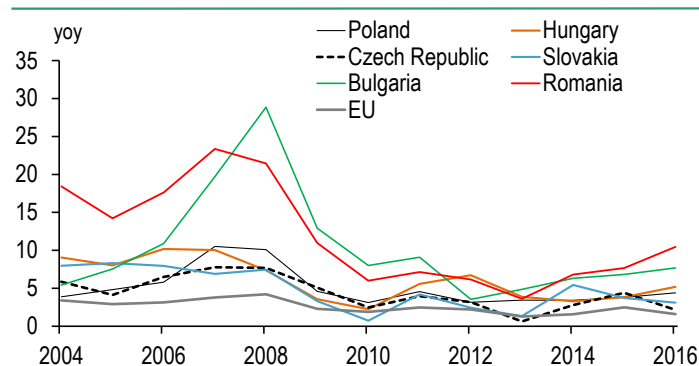


Chart 4

Sources: National statistics, Eurostat, BNP Paribas

Real wage - productivity gap

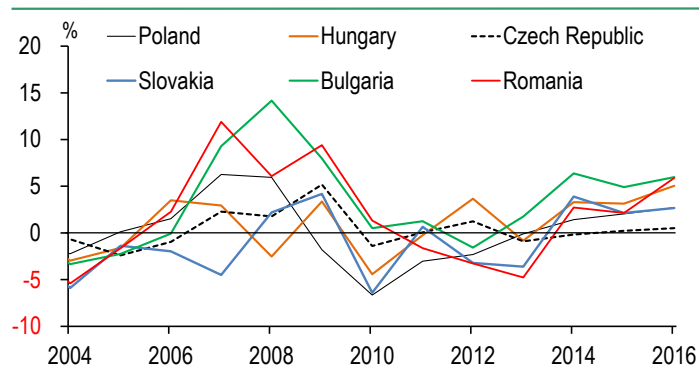


Chart 5

Sources: IMF, Eurostat, European Commission, BNP Paribas

This can be attributed to government measures both to reduce unemployment and to increase the active population, notably by setting up large-scale public works programmes to create jobs and to attract discouraged workers who had given up on the labour market after long and unsuccessful job searches.

Historic decline in unemployment...

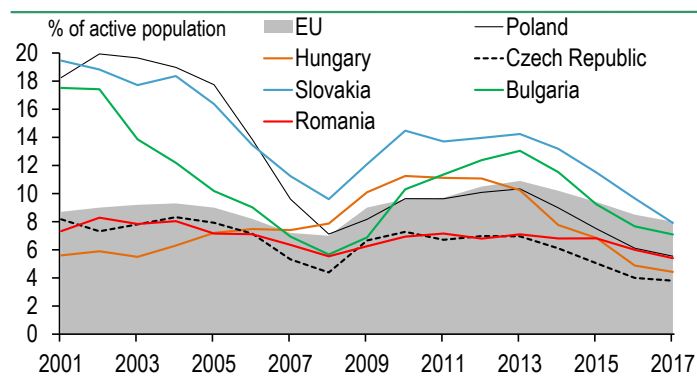


Chart 6

Sources: Eurostat, BNP Paribas

...facilitated by an alarming decline in the active population

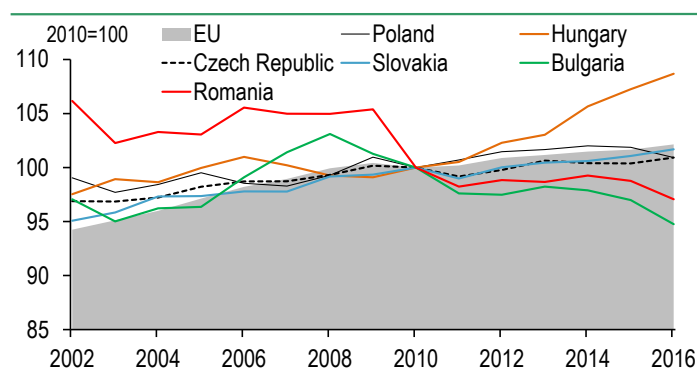


Chart 7

Sources: Eurostat, BNP Paribas

Buoyant export growth

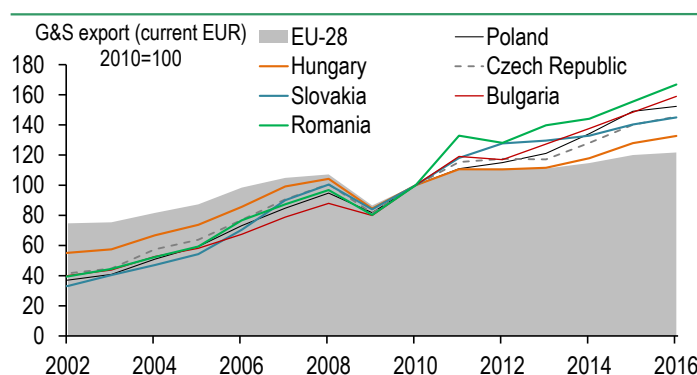


Chart 8

Sources: Eurostat, BNP Paribas

Under these conditions, posted workers only aggravate tensions in the short term. The V-6 countries are net suppliers of posted workers: in 2015 (the most recently available figures), posted workers accounted for 2% of the active population in Poland, 3% in Slovakia, and 1% in Hungary and Romania. The most recent estimates point to the amplification of this trend. Efforts to reform the European directive on posted workers are still highly controversial. The defensive positions of the countries that are net suppliers of posted workers (from the East and South of the Union) are encountering growing reticence from the countries that are net receivers of such workers fearing social dumping. Although the posted workers reform has been announced, the negotiations promise to be long and complicated. Consequently, the departure of workers towards other EU countries offering higher wages will continue to drain labour in the V-6 countries.

All of these factors support the idea of ongoing wage acceleration. The shortage of skilled labour will continue, and will require specific policies, notably in terms of vocational training and the development of child care facilities. The latter is needed to increase the female participation rate, which is lower than the EU average despite equal access to education.

Relations with the EU: seeking a new balance of power

While the recent trends in trade integration and the stock of foreign direct investment point to stabilization, the impact of European structural funds as a vector of integration and development of the eastern European countries gained power. The EU budget of 2014-2020 envisages a substantial increase in structural funds' flows to V-6 countries, fuelling large-scale infrastructure projects. In contrast, political relations between Brussels and the new member states have soured. Several thorny issues have emerged, notably concerning posted workers and migration quota policy. Political reforms introduced in some countries have also created tension, further complicating the negotiations even more complicated.

Stabilisation of foreign trade and FDI

Exports remain a major axis for convergence and regional development, although its importance seems to be levelling off. V-6 exports' growth exceeds the EU average (chart 8). The European Union still plays a preponderant role in the foreign trade of the V-6 countries, accounting for 79% of total exports of goods and services and for 75% of imports in 2016. Paradoxically, the EU's share of total V-6 exports has remained basically flat since 2000 (chart 9). It even contracted in the period 2005-2013. In terms of imports, it was not until 2010 (2012 for Poland) that the EU weighed more as a supplier of goods and services. Averaging 75% in 2016, it's share in imports now exceeds the 2004 peak in all the V-6 countries except Poland, which seems to be lagging behind this trend by about two years (chart 10). On the whole, even though the weight of imports is expected to increase, the original Visegrad 4 (V-4) countries seem to have largely completed their integration within the European market, while trade with Romania and Bulgaria should continue to intensify.

The V-6 countries managed to seize the opportunities offered by the single European market to develop trade with other EU countries, as well as to integrate within supply chains at the European level.

The development of exports has relied heavily on foreign direct investment, another key vector of integration. After an accelerated accumulation during 2000-2008, the stock of FDI has tended to stabilise as a share of GDP (chart 11), at levels ranging from 40% of GDP for Romania to 90% of GDP for Hungary. This levelling off confirms the end of an era in which the massive inflow of FDI served as a vital source of growth for these countries (notably for investment). It also means that other sources of financing will need to be found to fund future growth.

EU funds: a cornucopia through 2020...

Structural funds have played a growing role among the new sources of financing growth in recent years. Starting from less than 1% of GDP in the first years following EU membership, net transfers of structural funds reached an average of 4% of GDP in 2015. The 2014-2020 budget is also generous, with gross transfers (i.e. excluding contributions) planned at 3% of countries' GDP on average. The substantial growth of EU structural funds flows towards the end of the 2000s helped to offset the recessionary impact of the credit crunch and the reduction in fiscal capacities following the 2008-2009 recession.

In 2016, the slowdown in financing due to the particularities of the European fiscal cycle² strained investment growth in the V-6 countries. Yet this was temporary and flows resumed in 2017. In the remainder of the fiscal period that lasts to 2020, the absorption of funds should grow further thus supporting new investment and growth³.

Will this policy be continued beyond 2020? A priori, the region will continue to receive structural funds, but we can reasonably expect that the EU will be less generous. First, after Brexit (the UK's exit from the EU), officially set for Q1 2019, the EU's financial capacity will be reduced. The UK currently makes a net contribution of about 20% to the European budget. Financial conditions will therefore be fundamentally different in the 2021-2027 cycle, which means the priorities of structural policies will have to be reviewed. Second, some countries, notably those of southern Europe, are currently hit by insufficient potential growth and high unemployment rates, accompanied by the erosion of the private sector's financing capacities, notably in terms of access to credit (due to ailing banking sectors), and the need to restore fiscal sustainability. Therefore the rebalancing of the funds flows to these countries may be put on the agenda of the negotiations on the funds' allocation for the next budget period.

² The 7-year budget cycle is based on investment projects in which the EU is not the sole investor. Projects must be co-financed. The new fiscal cycle began in 2014, but the funds for projects approved during the previous cycle (2007-2013) could still be used through 2016. The funds are organised on a project basis, which means they are not released in equal parts each year, but according to project advancement. The budget cycle reflects the time necessary to prepare investment projects: fund transfers are small at the beginning of the cycle and accelerate towards the end (with the possibility of absorbing funds 2 years after the budget period).

³ Knowing the gearing effect these projects can have on short and medium-term growth, certain governments, like Hungary, have made special efforts to accelerate the absorption of funds available for the period 2014-2020, thereby hoping to smooth the variations in the budget cycle. For domestic political reasons, they also hope to stimulate short-term growth.

Lastly, numerous controversies are arising with the EU, which threatens to retaliate through financial sanctions, which could take the form of cutbacks in European funding.

Exports to EU as a share of total goods & services exports

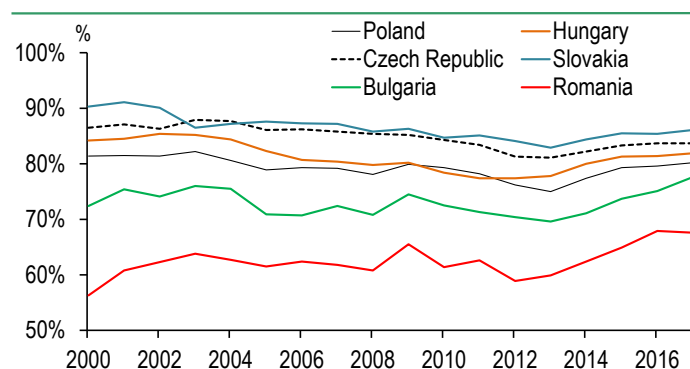


Chart 9 Sources: European Commission, BNP Paribas

Imports from EU as a share of total goods & services imports

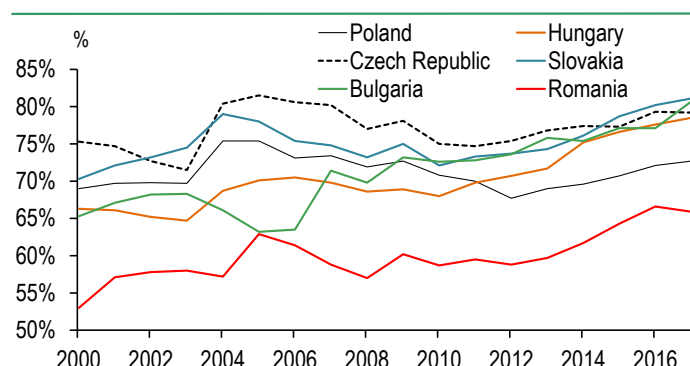


Chart 10 Sources: European Commission, BNP Paribas

Cumulative stock of FDI

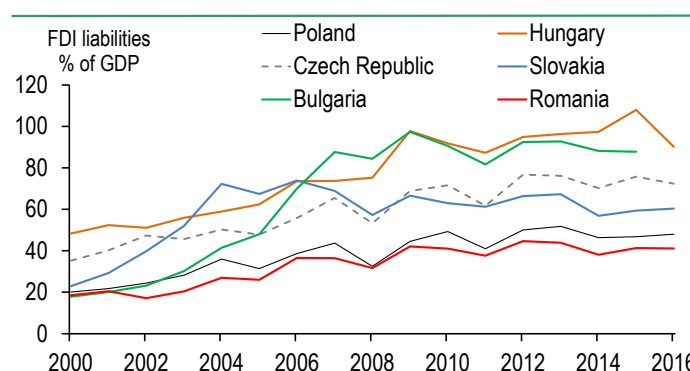


Chart 11 Sources: European Commission, BNP Paribas

Political relations: controversies emerge

Several controversies have sprung up recently between the eastern European countries and Brussels, notably over migrant quotas. Backed by public opinion, the governments have refused to comply with EU demands⁴. In June 2017, the EU opened procedures that aim to sanction Hungary and Poland for not respecting Brussels' decision on the reallocation of refugees.

Another thorny issue souring east-west relations is the reform of the posted workers directive. This directive allows European residents to work temporarily in another EU country without being subject to local social contributions. As a result, the western and southern countries of the EU, which have higher wage and social contribution rates, are attracting substantial flows of (cheaper) posted workers. Yet many of these countries also have high unemployment rates. Eastern European countries, which pay relatively lower wages, are net suppliers of posted workers. The reform, aiming at combating social dumping, looks to subject posted workers to the same conditions as the local labour force. The reduction of the maximum period to which the worker may be sent to another country without paying local social contributions (which is of 36 months currently) to 12 months over a period of 2 years, which should oblige all workers willing to work for longer to comply with the regulations of the receiver country is notably among the possibilities. Despite very low unemployment rates and the need to retain skilled workers (see below), the eastern European countries do not welcome this reform. Negotiations promise to be long and complicated, and for the moment, there are no signs of a consensus emerging.

In addition, the political reforms implemented in Hungary in 2013 and in Poland in 2015-2017 angered Brussels that perceived it as endangering the balance of power necessary for the smooth functioning of a democracy. European institutions do not really have the capacity to change the decisions of the national authorities, despite several threats of sanctions. European leaders are frustrated with the uncooperative positions taken by new member states, which largely benefit from the transfer of structural funds, but are reluctant to embrace decisions made collectively, despite the benefits for the EU as a whole. It is in the interest of all parties to reach a compromise position (and then to implement it), which will be vital if they are to avoid cumbersome warning procedures and sanctions. But we cannot rule out the possibility that more conflictual choices will prevail, lasting tensions and ending in a loss of confidence in the convergence process.

Macro-financial convergence

An analysis of financial indicators shows that the V-6 countries have made notable progress towards macro-financial convergence, and some have even completed the process. Starting from very disparate levels and dynamics, inflation and interest rates are now evolving within a very narrow band. The convergence of inflation rates determines the

convergence of monetary policies, notwithstanding the Eurozone's membership.

Inflation and interest rates

Looking retrospectively at inflation dynamics since 2000, we can see that the inflation rates have moved sharply closer, despite very different initial situations and independently of foreign exchange policies. Poland, Hungary and Romania use floating exchange rates, Slovakia adopted the euro in 2009, Bulgaria uses a fixed exchange rate as part of a currency board, and the Czech National Bank introduced a floor rate between November 2013 and April 2017 to limit the koruna's appreciation.

In the early 2000s, the countries of the region reported very disparate inflation rates, exceeding the EU average. In 2000, annual inflation neared 50% in Romania but was only 2% in the Czech Republic (chart 12). The 2008-2009 shock marked the beginning of synchronisation, and this movement intensified after 2012. By 2017, inflation rates in the eastern EU countries were bunched closely together, and differed little from the EU average. Today, they are just slightly below the ECB's price stability target (annual rate of 2%).

Yet despite the convergence of inflationary trends that is obvious, there are still significant price level differentials when compared with the old Eurozone member countries (EU-15). The spread is even wider for the non-tradable sectors, those in which goods cannot be traded internationally. According to European Commission estimates, in 2014 the prices of tradable consumption and investment goods in the new member countries amounted to 80% and 85%, respectively, of average prices for the EU-15, while prices of non-tradable goods were only 50% of the EU-15 average, with high disparities between countries. The convergence of price levels makes the central banks' task even harder, because it needs letting exchange rates appreciate, hampering the competitiveness of tradable sectors and increasing risks of bubble formation, in particular for the real estate.

The convergence and decline in inflation rates have paved the way for a significant improvement in financing conditions in domestic currencies for governments and the private sectors.

The alignment of interest rates is very visible for government bonds (see chart 13 for 10-year government bonds): after the two shocks of 2009 and 2012, which correspond to periods of financial markets' stress, government bond yields dropped to very low levels, very close to those of German Bund. Except the recent widening of spreads for Poland and Hungary which is due to political tensions with Brussels (see supra) and should be temporary, general trend points to narrowing spreads and declining rates. Although interest rates could become more volatile again in the eastern European countries, the current decline significantly improves the financing conditions for their governments. Some, like Hungary, quickly took advantage of this situation by launching a programme to favour domestic financing in the local currency over foreign currency financing on international markets. As a result, it has reduced both currency risk and the debt servicing costs (see chart 14). Other countries have also benefited from this rate effect.

⁴ Hungary and Slovakia filed a complaint with the European Court of Justice in 2015. Although the Court ruled against them in July 2017, the two countries, along with the Czech Republic, continue to refuse to comply with the migrant quotas.



Inflation: spectacular convergence

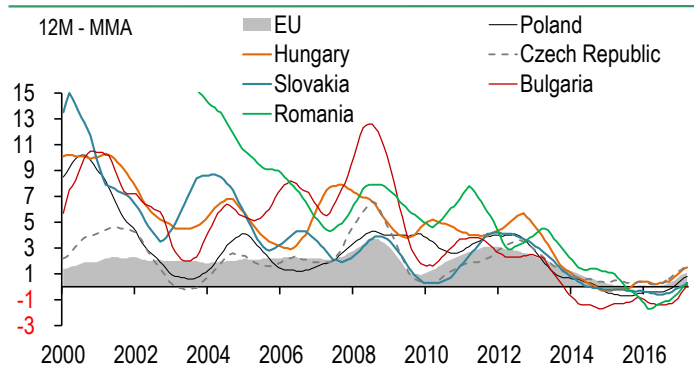


Chart 12

Sources: Eurostat, BNP Paribas

Corporate lending rates

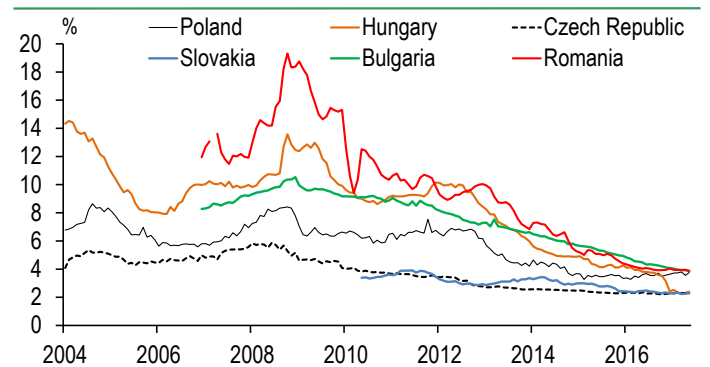


Chart 15

Sources: ECB, BNP Paribas

Government lending rates: convergence resumes after a double shock

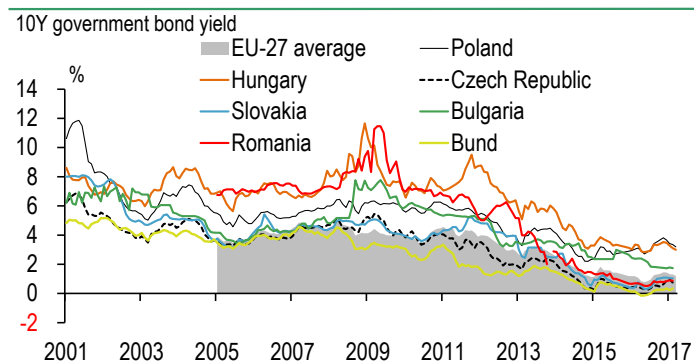


Chart 13

Sources: Reuters Datastream, BNP Paribas

Real interest rates (adjusted for the consumer price index)

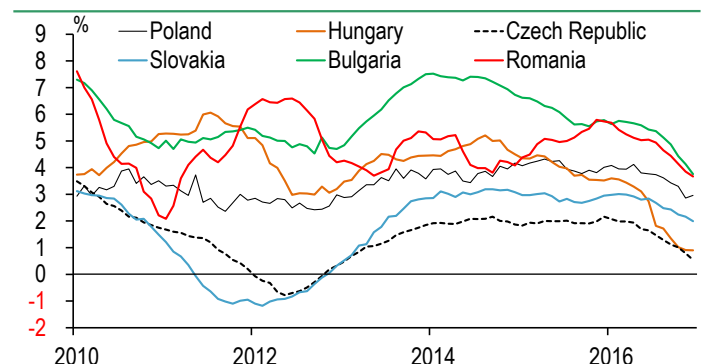


Chart 16

Sources: ECB, Eurostat, BNP Paribas

Debt service cost

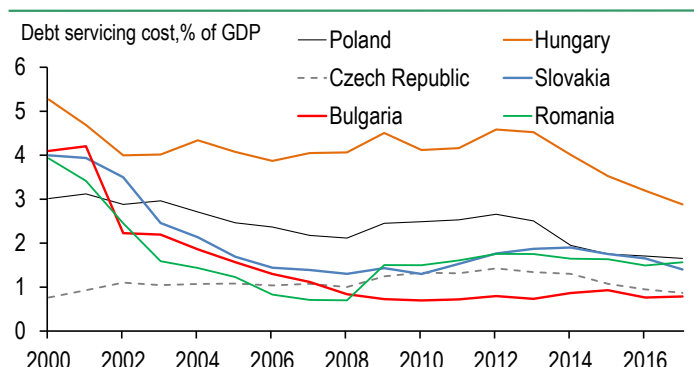


Chart 14

Sources: European Commission, BNP Paribas

Credit growth: slow start-up after prosperous years

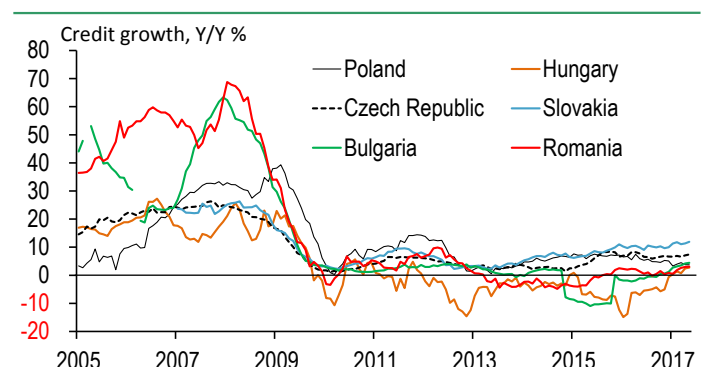


Chart 17

Sources: European Commission, BNP Paribas

Private sector lending rates have followed similar trajectories, leading to better credit conditions. However, the decline in interest rates alone was not enough to pull these countries out of the credit crunch that struck after the bursting of credit bubbles in 2009. The Czech Republic, Slovakia and Poland were only hit by a sharp slowdown in lending to the private sector, but Bulgaria, Romania and Hungary entered a long period without any new bank financing. It was not until 2016 that lending to the private sector finally swung back into growth (chart 17). During this period, the V-6 banks managed to restore their external positions, and deposits became their main source of balance sheet financing again.

Although the resulting credit growth is milder than before the crisis, bank loans are now contributing to financing growth. With historically low nominal interest rates, and the decline in real interest rates since 2013 (a trend reinforced in 2016, chart 16), the environment is increasingly favourable for long-term financing in the local currency. The loan-to-GDP ratio averages 50% for the V-6 countries (with a range from 28% of GDP for Romania to 57% of GDP for Slovakia at year-end 2016), which is still much lower than the European average of 97% of GDP. This highlights the development potential for lending. The conditions have come together for the banking sector to begin growing again, assuming it avoids the excesses of 2004-2008.

Fewer macroeconomic imbalances

The 2009 financial crisis has left its mark. Public finance metrics deteriorated sharply and most of the countries under review suddenly found themselves facing excessive deficit procedures, launched by the European Commission in 2009-2010, and completed between 2013 and 2015. Poland, the only V-6 country to avoid recession in 2009, was the last to exit the excessive deficit procedure in 2015. Public debt increased by 15 points of GDP on average between 2007 (the last year before the crisis) and 2016. Even so, public debt was still lower than the averages for the EU (chart 18) and the Eurozone. With the exception of Hungary, the other countries all have public debt ratios of less than 60% of GDP, which means they still respect the EU's convergence criteria. Hungary has reduced its debt since 2011, bringing the debt ratio to 74% of GDP in 2016. According to the latest IMF estimates, its debt should continue to contract to 70% of GDP in 2020 and remain below the EU average.

Hungary and Romania had to request international assistance to cope with the financial crisis' balance-of-payments shock. Hungary benefited from a stand-by arrangement with the IMF for SDR10.5bn in place between November 2008 and October 2010, of which SDR7.6bn was effectively drawn. Romania also called on IMF funding between 2009 and 2011, with a stand-by arrangement of SDR11bn that it used almost completely, as well as stand-by facilities through 2015 (the last lines of which were not used). Poland still benefits from a precautionary line: opened for the first time in 2009, but never used, it was renewed for another 2 years in January 2017 (albeit for a smaller amount of SDR6.5bn).

Exchange rates have remained stable since 2010, after two decades of high volatility and the shock of the financial crisis in late 2008. Slovakia

definitively adopted the euro in 2009, and Bulgaria has maintained its fixed exchange rate policy (via a currency board set up in 1997). External liquidity has improved: the foreign reserves of the V-6 countries have generally increased since 2010, with the exception of Hungary. Reserves are now sufficiently high to absorb a moderate global liquidity shock. Current accounts have turned around since 2009, and most of the countries generate either a current account surplus or a very small deficit (Poland). The big exception is Romania, where vigorous domestic demand maintains the deficit above 2% of GDP, which is a far cry from the 15% of GDP reported in 2007. External debt has also tended to decline since 2012, although it is still high at an average of 76% of GDP. Intra-group loans account for about a quarter of this debt (between 21% for Slovakia and 51% for Hungary at year-end 2016), mitigating external liquidity risk. All in all, balance-of-payments risks have been reduced, and the V-6 countries seem to be better armed to handle global liquidity shocks.

Public debt

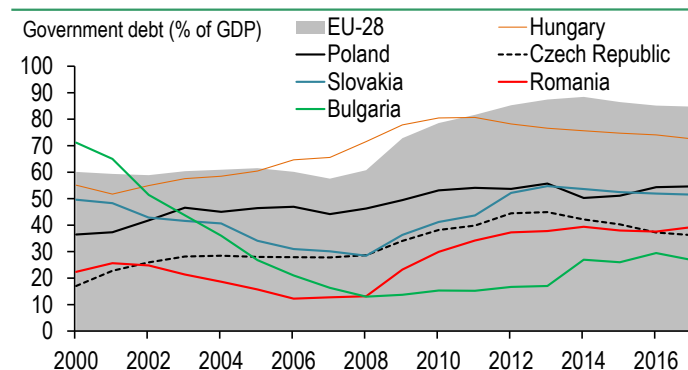


Chart 18

Sources: Eurostat, BNP Paribas

Structural challenges

Although macroeconomic convergence has progressed well, the V-6 countries still face numerous medium and long-term challenges. The time is ripe to tackle these challenges: with renewed growth, healthier banks and abundant EU funding, the countries have the necessary resources to deal with them. First, there are the demographic problems arising from the drop-off in birth rates and massive emigration. A key objective for structural policy is to shift the value chain upmarket, and to redirect production facilities towards goods with higher innovation content. Industrial sectors that are already well integrated in global supply chains must participate more actively in world technical progress.

Demographics: declining birth rates and massive emigration

Birth rates in the V-6 countries have collapsed since 1990. The situation improved slightly in the 2000s, but this proved to be short-lived as birth rates began contracting again with the 2009-2010 crisis. In all of the countries under review, birth rates are below the EU average, and well below the population replacement rate of 2.1 children per woman (chart 20).



Exchange rates

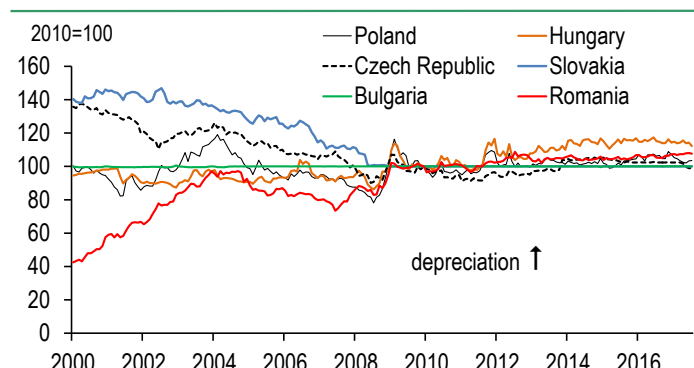


Chart 19 Sources: Reuters Datastream, BNP Paribas

Birth rate

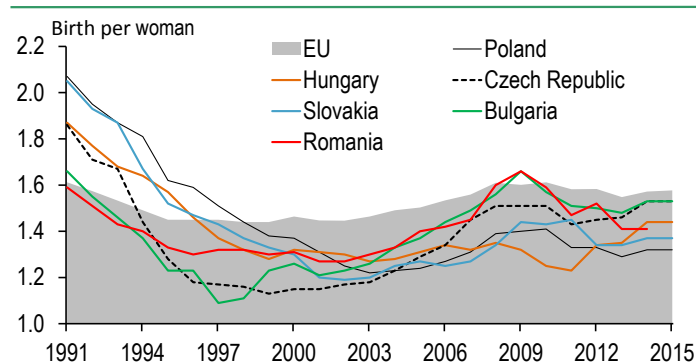


Chart 20 Sources: World Bank, BNP Paribas

Demographic forecast for 2040

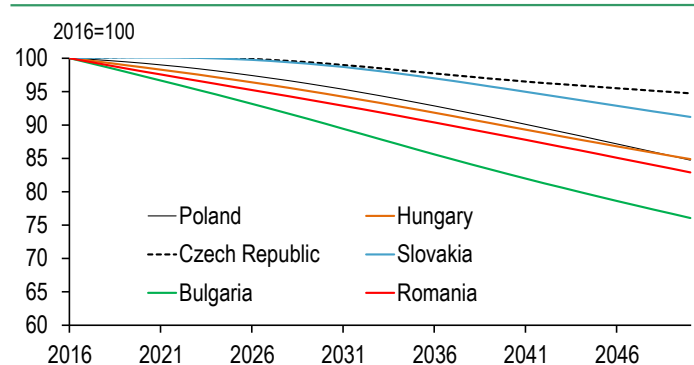


Chart 21 Source: United Nations

The problem of declining birth rates is exacerbated by emigration. According to IMF estimates (2016)⁵, between 2009 and 2012 the

original V-4 countries lost about 9% of their population due to emigration towards other countries with higher revenues. The decline is closer to 15% in Bulgaria and Romania. Emigration mainly affects young and skilled (and even highly skilled workers). The overall impact on growth in the “source” countries is negative, despite the boost to consumption and investment in construction from remittances. The brain drain is reducing potential growth rates, thereby slowing their convergence and negatively impacting competitiveness of the private sector. The impact on public finances is also negative because governments are obliged to maintain a high level of social spending on the remaining inactive population, which leaves little manoeuvring room for other spending, notably on investment and development.

According to Coface estimates (2017)⁶ for the recent period (2010-2014) emigration flows amounted to 19% of the total population in Romania, 14% in Bulgaria, 9% in Poland and Slovakia, 7% in Hungary and 2% in the Czech Republic. In addition, the authorities and public opinion in these countries are still highly opposed to the massive inflow of immigrants, which could offset the labour shortage in the short term. The only interest that has been shown is for Ukrainian immigrants, notably in Poland, for reasons of cultural and linguistic proximity. Net migratory flow in Poland switched to positive in 2016, after several years in negative territory. For the moment, overall migratory flows are slightly positive in the Czech Republic and Slovakia. Yet Bulgaria and Romania still seem to be finding it difficult to limit emigration and/or to attract foreign labour to compensate for it (chart 22).

Yet even if Brexit may reduce emigration somewhat, the persistence of negative migratory flows, despite higher revenues and the decline in unemployment, calls for government action, notably by creating attractive conditions to encourage skilled workers to return home and more generally improving the institutional framework. All of the region's governments have announced pro-family policies. Poland, which has the lowest birth rate of the V-6 countries (1.31 children per woman), and one of the lowest in the world, has launched 500+, its first family allowance programme: families with two or more children will receive a monthly allowance of 500 zlotys (EUR 117).

Hungary intends to raise the average birth rate from the present level of 1.5 children per woman to a target of 2.1 by 2030. To achieve this, the government intends to adjust student loan reimbursements (which will be cut in half for women with two children, and totally cancelled with the birth of a third child). It also plans to grant home loan subsidies of up to HUF 1 mn (EUR 3200) per child. The government will launch programmes to develop childcare centres and nurseries, in order to increase the female participation rate. Tax reductions for families with two or more children are also being studied: the total budget for families could account for as much as 5% of GDP. The other countries are also showing their political determination to combat depopulation, although they are committing fewer financial resources. Since a massive inflow of immigrants to replace declining active populations does not seem to be a politically feasible option, efforts will have to focus on increasing the total participation rate (notably by supporting female participation

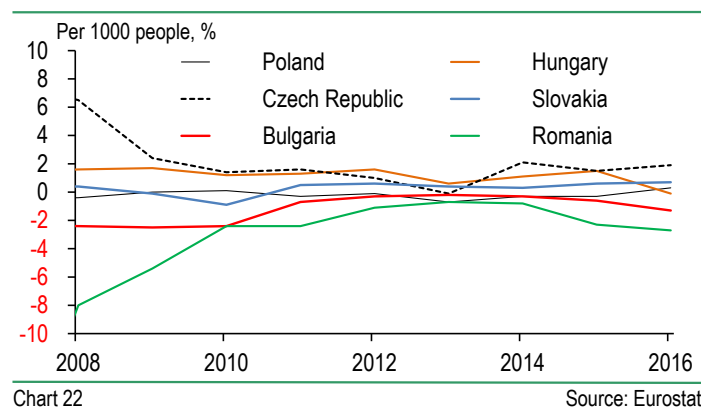
⁵ Atoyan et al. (2016) *Emigration and its Economic Impact on Eastern Europe*, IMF Staff Discussion Note, July, SDN/16/07

⁶ Fruchter D. Selewicz G. (2017) *Labour Shortages in Central and Eastern Europe Countries: a growing concern for businesses*, Coface Economic Publications, May



through the development of childcare facilities, which have disappeared since the 1990s) and raising productivity.

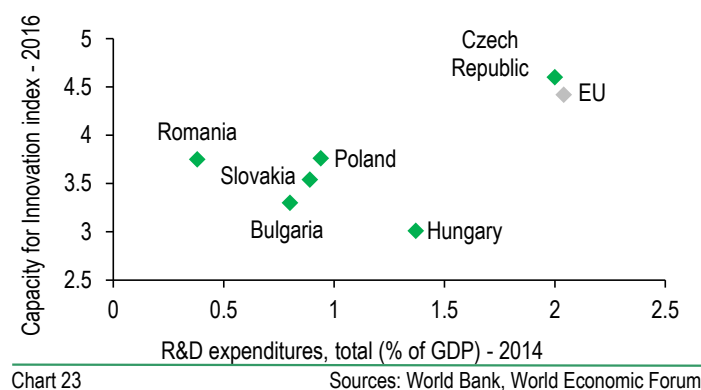
Net migration rates



Innovation, the key to development

For the V-4 countries (Poland, Hungary, Czech Republic and Slovakia), integration in the European supply chain seems to be very advanced, while Bulgaria and Romania, which accessed the single market much later, have made substantial progress. Yet furthering convergence and maintaining revenue growth will run up against competition from other countries with even lower wages. The V-4 countries seem to be approaching the limit beyond which pursuing wage and revenue growth will undermine competitiveness.

Innovation capacity



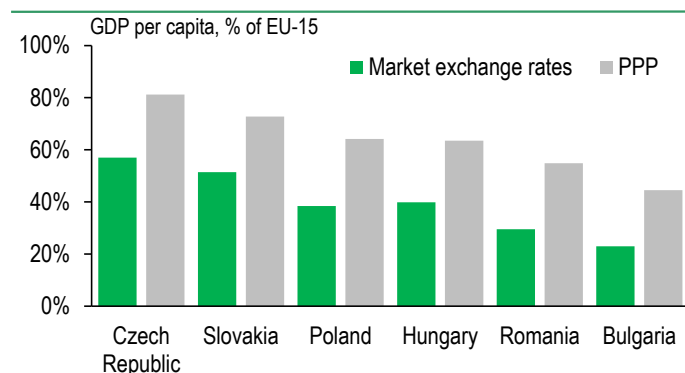
To extract themselves from this situation, called a "middle income trap", they must shift production upmarket and develop more innovative, higher value added products. It is vital to accelerate investment in innovation, research and development as part of their development strategy.

Yet with the exception of the Czech Republic, the V-6 countries have fallen behind the EU average in terms of R&D investment and their

capacity to innovate (chart 23). Innovation policies require long-term investments that are often risky, and need government participation (to organise or provide financing, or to ensure against risks). Given today's very favourable conditions, the situation must be tackled without delay. Public finances are in better health, the institutional environment has improved tremendously over the past decade, and financial stabilisation now makes long-term financing possible.

The Polish authorities have clearly grasped the challenge at hand. The government adopted the Morawiecki plan to pull the country out of a middle income trap and a mid-range producer trap, while supporting balanced growth. The plan calls for major investment efforts, notably by calling on European funds, to boost the investment rate to 25% of GDP from 18% presently, while encouraging investment in new technologies and boosting exports.

Still a long way to go



Hungary took advantage of the European Union's expertise and advice: as part of its 2016 Policy Support Facility, the EU conducted an in depth review of Hungary's research and innovation system and made 33 specific recommendations⁷. The report recognises the country's innovative potential, but insists on the need for a coordinated policy with precise targets. Hungary has already set up a national office for research, development and innovation that is responsible for coordinating policies. The government intends to promote products "invented in Hungary" (as opposed to "made in Hungary"), notably via tax incentives. According to the OECD, of the V-6 countries, the Czech Republic spends the most on innovation, with an expenditure rate slightly above the EU average. It is counting heavily on private investment. These countries are also working to make investments more effective and to better coordinate the efforts of the various institutions participating in their innovation policies. Slovakia has long bet on technology imports via multinational subsidiaries. It is strengthening its arsenal of support for innovation by defining priority sectors; expanding guaranteed loan mechanisms and risk sharing; favouring venture capital programmes; and introducing tax incentives.

⁷ EU Commission (2016) *Peer Review of the Hungarian Research and Innovation System*, Horizon 2020 Policy Support Facility



According to the European Commission⁸, Bulgaria is suffering from the excessive segmentation of players in its innovation policy and needs to better coordinate research and the corporate world. All the V-6 countries have set up programmes to improve the effectiveness of public research and to reinforce the link between the academic and corporate worlds.

All in all, the region's authorities now seem to fully understand the interest of innovation⁹. Of course, these programmes have substantial implementation risks. Yet their capacity to take advantage of the today's strong economic momentum will be decisive for ensuring the "qualitative leap" necessary to complete the convergence process first launched in 2004.

Conclusion

The countries of Eastern Europe are in the midst of a buoyant recovery that is bound to continue. Macroeconomic conditions are favourable for consumption to accelerate, bolstered by wage acceleration and strong investment, thanks notably to the inflow of European structural funds. Macroeconomic imbalances have diminished over the past four-five years, improving financial stability.

The emergence of controversies in their relations with the EU suggests that the political honeymoon has come to an end. National political forces are more mixed about the need to pursue and deepen relations with Brussels. Moreover, the lack of political will to provide solidarity efforts raises doubts among the older EU member countries about the need to continue massively supporting development in these countries. A new phase is beginning in which it will be vital to seek compromise at the political level.

The manna of European structural funds will likely diminish after 2020. These funds will no longer play the same role of driving growth. The countries will have to find other sources of financing for growth, and will have to rely more on domestic savings. Challenges remain: orchestrating a demographic revival while investing massively in innovative industries. The governments' capacity to meet these challenges will have a decisive impact on convergence.

Completed on 12 September 2017
anna.dorbec@bnpparibas.com

⁸ EU Commission (2015) *Peer Review of Bulgaria's Research and Innovation System*, Horizon 2020 Policy Support Facility

⁹ For further information on the policies set up on a country basis, see for example, <https://www.innovationpolicyplatform.org>



GROUP ECONOMIC RESEARCH

■ **William DE VIJDER**
Chief Economist

+33.(0)1 55 77 47 31

william.devijlder@bnpparibas.com

ADVANCED ECONOMIES AND STATISTICS

■ **Jean-Luc PROUTAT**
Head

+33.(0)1.58.16.73.32

jean-luc.proutat@bnpparibas.com

■ **Alexandra ESTIOT**

Works coordination - United States - United Kingdom - Globalisation

+33.(0)1.58.16.81.69

alexandra.estiot@bnpparibas.com

■ **Hélène BAUDCHON**

France (short-term outlook and forecasts) - Labour markets

+33.(0)1.58.16.03.63

helene.baudchon@bnpparibas.com

■ **Frédérique CERISIER**

Euro Area (European governance and public finances), Spain, Portugal

+33.(0)1.43.16.95.52

frederique.cerisier@bnpparibas.com

■ **Thibault MERCIER**

Euro Area (short-term outlook and monetary policy), France (structural reforms)

+33.(0)1.57.43.02.91

thibault.mercier@bnpparibas.com

■ **Catherine STEPHAN**

Nordic countries - World trade - Education, health, social conditions

+33.(0)1.55.77.71.89

catherine.stephan@bnpparibas.com

■ **Raymond VAN DER PUTTEN**

Germany, Netherlands, Austria, Switzerland - Energy, climate - Long-term projections

+33.(0)1.42.98.53.99

raymond.vanderputten@bnpparibas.com

■ **Tarik RHARRAB**

Statistics and Modelling

+33.(0)1.43.16.95.56

tarik.rharrab@bnpparibas.com

BANKING ECONOMICS

■ **Laurent QUIGNON**
Head

+33.(0)1.42.98.56.54

laurent.quignon@bnpparibas.com

■ **Céline CHOULET**

+33.(0)1.43.16.95.54

celine.choulet@bnpparibas.com

■ **Thomas HUMBLLOT**

+33.(0)1.40.14.30.77

thomas.humblot@bnpparibas.com

EMERGING ECONOMIES AND COUNTRY RISK

■ **François FAURE**
Head - Argentina

+33.(0)1 42 98 79 82

francois.faure@bnpparibas.com

■ **Christine PELTIER**

Deputy Head - Greater China, Vietnam, North Asia countries, South Africa

+33.(0)1.42.98.56.27

christine.peltier@bnpparibas.com

■ **Stéphane ALBY**

Africa (French-speaking countries)

+33.(0)1.42.98.02.04

stephane.alby@bnpparibas.com

■ **Sylvain BELLEFONTAINE**

Turkey, Brazil, Colombia, Mexico, other Latin American countries

+33.(0)1.42.98.26.77

sylvain.bellefontaine@bnpparibas.com

■ **Sara CONFALONIERI**

Africa (Portuguese & English-speaking countries)

+33.(0)1.42.98.43.86

sara.confaloneri@bnpparibas.com

■ **Pascal DEVAUX**

Middle East, Balkan countries

+33.(0)1.43.16.95.51

pascal.devaux@bnpparibas.com

■ **Anna DORBEC**

CIS, Central European countries

+33.(0)1.42.98.48.45

anna.dorbec@bnpparibas.com

■ **Johanna MELKA**

India, South Asia, Russia

+33.(0)1.58.16.05.84

johanna.melka@bnpparibas.com

■ **Michel BERNARDINI**
Contact Média

+33.(0)1.42.98.05.71

michel.bernardini@bnpparibas.com



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 Registered Office: 16 boulevard des Italiens – 75009 PARIS
 Tel: +33 (0) 1.42.98.12.34 – www.group.bnpparibas.com
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